IT 99-0011-PLR 12/20/1999 SUBTRACTION MODIFICATIONS – OTHER RULINGS

> Private Letter Ruling: Income deemed received from Qualified Zone Academy Bonds issued by the Illinois Development Finance Authority is excluded from net income under 20 ILCS 3505/7.61.

December 20, 1999

Dear:

This is in response to your letter dated December 16, 1999, in which you request a Private Letter Ruling on behalf of xxxxxxxxxxxxx. Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of the enclosed copy of Section 1200.1120 appears to be contained in your request. The Private Letter Ruling will bind the Department only with respect to xxxxxxxxxxxxxx for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither xxxxxxxxxxxxxx nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented them are as follows:

> This is a request for a Private Letter Ruling, pursuant to Ill. Admin. Code Title 2, Section 1200.110(a), on behalf of the following taxpayer: xxxxxxxxxxxxxx (the "Taxpayer"). I am submitting this request as the representative of the Taxpayer. The subject matter of this request was previously addressed by the Department in a General Information Letter, dated December 1, 1999, issued to the Illinois State Board of Education.
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> **INFORMATION REQUIRED BY IDOR REGULATIONS**
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> In accordance with Ill.Admin. Code Title 2, Section 1200.110(b), the following information is provided in support of this request:
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> (1) The facts and other information included in this request are a statement of facts and other information pertinent to this request. This request contains a complete statement of all material facts and an analysis of the material facts to the issues presented.
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> (2) Attached to this request are all contracts, agreements, instruments and other documents relevant to this request.
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> (3) The tax period at issue is calendar year 2000 and any subsequent tax year during which the Taxpayer owns a QZAB Bond issued by IDFA (as described below). There is no audit or litigation pending with the Department with respect to this issue.
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> (4) To the best of my knowledge, as the representative of the Taxpayer, the Department has not previously ruled on the issue presented in this letter or in any other way commented on this issue (except for the General Information Letter referred to above).
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> (5) The authorities supporting the views of the Taxpayer, an explanation of the grounds for the conclusion reached by the Taxpayer and the relevant authorities supporting that conclusion are set forth below.
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> (6) I have been unable to locate any authorities that are contrary to the views set forth in this letter.

(7) I request that the name of the Taxpayer and the amount and description of the QZAB Bonds purchased by the Taxpayer be deleted from any publicly disseminated version of your private letter ruling.

(8) I am executing this letter as the representative of the Taxpayer. A properly executed power of attorney is attached as Exhibit A to this request.

DISCUSSION

Plan of Finance

Pursuant to an allocation issued by the Illinois State Board of Education ("ISBE"), the Illinois Development Finance Authority ("IDFA") will issue "qualified zone academy bonds" under the provisions of Section 1397E of the Internal Revenue Code of 1986, as amended (the "Code.") Section 1397E was added to the Code by the Taxpayer Relief Act of 1997. This provision authorizes the issuance of "federal tax credit" qualified zone academy bonds ("QZAB Bonds") to finance educational improvements at public schools that serve large numbers of children of low-income families. (ISBE has previously stated that the issuance of QZAB Bonds by IDFA will serve important public purposes for the State of Illinois, in particular by providing low-cost financing for five local school districts to upgrade and expand their capital facilities and infrastructure.)

IDFA will issue four series of QZAB Bonds, in the aggregate principal amount of approximately $14,000,000, under its Local Government Financing Assistance Program, 20 ILCS 3505/7.50—7.61 (the "Local Government Assistance Program"). It is expected that these QZAB Bonds will be issued and delivered on December 22, 1999, for the benefit of the following schools districts in the State of Illinois:

Name of School District	Approximate Amount of QZAB Bonds
xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx (Series xxxxx)	$xxxxxxxxxx
xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx (Series xxxxx)	xxxxxxx
xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx (Series xxxxx)	xxxxxxx
xxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxx (xxxxxxxxxxxx)	xxxxxxx

The Taxpayer is purchasing all of the QZAB Bonds described in the above table. A specimen QZAB Bond is attached as Exhibit B.

QZAB Legislation

Section 1397E was enacted in 1997 to provide new federal tax incentives that would encourage and support critically-needed financing of educational improvements substantially benefiting low-income children and to promote cooperation between local school districts and local businesses in the funding of these improvements.[1] QZAB Bonds are "federal tax credit" bonds, with an eligible taxpayer who is an owner thereof entitled to a credit against its federal tax liability, calculated in accordance with Section 1397E(b) (and the implementing regulations promulgated by the Internal Revenue Service in Temporary Regulation Section 1.1397E-1T), and equal to the product of the principal amount of QZAB Bonds held by the taxpayer and the applicable credit rate (which is established by the United States Department of Treasury at the time of issuance).[2]

In accordance with Section 1397E(b)(2) and Temporary Treasury Regulation Section 1.1397E-1T(b), the credit rate is to be established pursuant to a formula that is designed to permit the issuance of the QZAB Bonds "without discount and without interest cost to the issuer."[3] Section 1397E(g) further provides that the holder of a QZAB Bond must include the amount of the credit (calculated as described in the prior paragraph) in its gross income for federal tax purposes. To implement this provision in Section 1397E(g) Temporary Treasury Regulation Section 1.1397E-1T(f) specifically provides that the holder must treat the QZAB Bond "as if it pays qualified stated interest for purposes of Treasury Regulation Section 1.1273-1(c)." The amount of this "deemed payment of interest" is equal to the product of the QZAB Bond credit rate and the outstanding amount of QZAB Bonds owned by the holder on the date of calculation. Temporary Treasury Regulation Section 1.1397E-1T(e).

Local Government Assistance Program

The General Assembly has determined that the exercise of the powers granted to IDFA under the Local Government Assistance Program is in all respects for the benefit of the people of Illinois. As a result, bonds issued by IDFA under the Local Government Assistance Program "and the income therefrom shall be free from all taxation by the State or its political subdivisions except for estate, transfer and inheritance taxes." 20 ILCS 3505/7.61 (the "IDFA Act"); See also Ill. Admin. Code Title 86, Section 100.2470(f)(3); and Illinois Corporate and Replacement Tax Return, Form IL-1120.

To implement the provision exempting income on bonds issued under the Local Government Assistance Program from Illinois income taxation, the IDFA Act provides that "the amount of such income that shall be added and then subtracted on the Illinois income tax return of a taxpayer, pursuant to Section 203 of the Illinois Income Tax Act, from federal adjusted gross income or federal taxable income in computing Illinois base income shall be the interest net of any bond premium amortization." The corresponding provision of the Illinois Income Tax Act is Section 203(b) which provides as follows:

> (i) pursuant to sub-section (b)(2)(A), base income for Illinois income taxation shall be determined first by adding to federal taxable income: "An amount equal to all amounts paid or accrued to the taxpayer as interest and all distributions received from regulated investment companies during the taxable year to the extent excluded from gross income in the computation of taxable income"; and
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> (ii) pursuant to sub-section (b)(2)(J), base income for Illinois income taxation shall be determined by then

> deducting: An amount equal to all amounts included in such total which are exempt from taxation by this State either by reason of its statutes or Constitution or by reason of the Constitution, treaties or statutes of the United States; provided that, in the case of any statute of this State that exempts income derived from bonds or other obligations from the tax imposed under this Act, the amount exempted shall be the interest net of bond premium amortization.[4]

To date, all of the bonds issued by IDFA under the Local Government Assistance Program have been securities bearing interest at a stated rate. All or substantially all of these bonds have been securities, the interest on which is exempt from federal income taxation in accordance with the provisions of the Section 103 and Sections 141 through 150 of the Code (and the regulations promulgated thereunder). (As a result, bonds issued by IDFA under the Local Government Securities Program are generally referred to as "double tax-exempt," with the interest paid on these bonds being exempt from both federal and Illinois income tax.)

As stated above, the holders of the QZAB Bonds to be issued by IDFA under the Local Government Assistance Program will receive a federal tax credit in lieu of receiving interest that is exempt from federal income tax. However, a holder of a QZAB Bond is required to treat the QZAB Bond as if it pays stated interest and to pay federal income tax on an amount equal to the amount of this federal tax credit. The amount of this credit is therefore included in federal taxable income and will be included in "base income" for purposes of Section 203 of the Illinois Income Tax Act.

REQUEST FOR RULING

The Taxpayer seeks a private ruling from the Department that the amount of the federal tax credit, calculated as described in this letter and required to be included in federal taxable income as the equivalent of qualified stated interest, is to be treated as income that is excluded from Illinois base income for purposes of the IDFA Act and the Illinois Income Tax Act. The Taxpayer also requests advice as to how a holder of a QZAB Bond issued under the Local Government Assistance Program should properly reflect the exclusion of the amount of this federal tax credit from Illinois base income on Form IL-1120.

Ruling

Section 1397E of the Internal Revenue Code provides, in part:

> (a) Allowance of credit. In the case of an eligible taxpayer who holds a qualified zone academy bond on the credit allowance date of such bond which occurs during the taxable year, there shall be allowed as a credit against the tax imposed by this chapter for such taxable year the amount determined under subsection (b).
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> (b) Amount of credit.

> (1) In general. The amount of the credit determined under this subsection with respect to any qualified zone academy bond is the amount equal to the product of -
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> (A) the credit rate determined by the Secretary under paragraph (2) for the month in which such bond was issued, multiplied by
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> (B) the face amount of the bond held by the taxpayer on the credit allowance date.
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> (2) Determination. During each calendar month, the Secretary shall determine a credit rate which shall apply to bonds issued during the following calendar month. The credit rate for any month is the percentage which the Secretary estimates will permit the issuance of qualified zone academy bonds without discount and without interest cost to the issuer.

Under Section 1397E(d)(6) of the Internal Revenue Code, an "eligible taxpayer" who entitled to the special treatment on bonds governed by Section 1397E means a bank, an insurance company or a corporation engaged in the business of lending money.

Section 1397E(g) of the Internal Revenue Code provides:

> Gross income includes the amount of the credit allowed to the taxpayer under this section.

Temp. Reg. § 1.1397E-1T implements Section 1397E(g) of the Internal Revenue Code by providing as follows:

> (f) Treatment of the allowance of the credit as a payment of interest—
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> (1) General rule. The holder of a qualified zone academy bond must treat the bond as if it pays qualified stated interest (within the meaning of Sec. 1.1273-1(c)) on each credit allowance date. The amount of the deemed payment of interest on each credit allowance date is equal to the product of the credit rate and the outstanding principal amount of the bond on that date. Thus, for example, if the holder uses an accrual method of accounting, the holder must accrue as interest income the amount of the credit over the one-year accrual period that ends on the credit allowance date.
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> (2) Adjustment if the holder cannot use the credit to offset a tax liability. If a holder holds a qualified zone academy bond on the credit allowance date but cannot use all or a portion of the credit to reduce its income tax liability (for example, because the holder is not an eligible taxpayer or because the limitation in section 1397E(c) applies), the holder is allowed a deduction for the taxable year that includes the credit allowance date. The amount of the deduction is equal to the amount of the unused credit deemed paid on the credit allowance date.

The characterization in the regulation of the income recognized by a taxpayer under Section 1397E(g) as interest is consistent with the economic substance of the bonds governed by Section 1397E. Under that section, an amount computed in the same manner as interest on the bonds is included in the taxable income of the bondholder even though no payment of the interest is actually made or anticipated, and that amount is also allowed as a credit against the bondholder's federal income tax liability. The effect is exactly the same as if the federal government paid interest on the bond on behalf of the issuer. In that case, the bondholder would clearly have interest income subject to tax, but there would be no net payment of interest because the tax payable by the bondholder to the federal government would exactly offset the interest payable by the federal government to the bondholder. Accordingly, characterizing the income deemed received by the bondholder as interest is consistent with the statute.

You have represented that the bonds in question will be issued pursuant to the authority granted under Sections 7.50 through 7.61 of the Illinois Development Finance Authority Act (20 ILCS 3505/7.50 - 7.61), Section 7.61 of that Act provides as follows:

> The exercise of the powers granted in Sections 7.50 through 7.61 of this Act are in all respects for the benefit of the people of Illinois and in consideration thereof the bonds issued pursuant to the aforementioned Sections and the income therefrom shall be free from all taxation by the State or its political subdivisions, except for estate, transfer and inheritance taxes. For purposes of Section 250 of the Illinois Income Tax Act, the exemption of the income from bonds issued under the aforementioned Sections shall terminate after all of the bonds have been paid. The amount of such income that shall be added and then subtracted on the Illinois income tax return of a taxpayer, pursuant to Section 203 of the Illinois Income Tax Act, from federal adjusted gross income or federal taxable income in computing Illinois base income shall be the interest net of any bond premium amortization.

Section 203(b)(2)(J) of the Illinois Income Tax Act (35 ILCS 5/203(b)(2)(J)) provides that, in computing its net income subject to Illinois income taxation, a corporation is allowed to subtract from its federal taxable income:

> An amount equal to all amounts included in such total which are exempt from taxation by this State either by reason of its statutes or Constitution or by reason of the Constitution, treaties or statutes of the United States; provided that, in the case of any statute of this State that exempts income derived from bonds or other obligations from the tax imposed under this Act, the amount exempted shall be the interest net of bond premium amortization.

Because Section 7.61 of the Illinois Development Finance Authority Act exempts the income from the bonds in question from Illinois income taxation, xxxxxxxxxxxxxx, as a holder of such bonds, is allowed the subtraction provided in this subsection. This subtraction should be claimed on Part I, Line5f of the Form IL-1120. Moreover, because the federal taxable income recognized by the taxpayer as the result of the operation of Section 1397E(g) of the Internal Revenue Code is, in substance, interest on the bond, such subtraction shall be net of the applicable amortization of any premium paid by the taxpayer upon acquisition of the bond. Finally, please note that Section 201(b)(2)(J) allows a subtraction only for the amount of income from the bonds actually included in federal taxable income, plus addition modifications. Thus, to the extent xxxxxxxxxxxxxx is allowed a deduction under Temp. Reg. § 1.1397E-1T(f)(2) because it is unable to use some or all of the credit, its subtraction modification will also be reduced.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

Very truly yours,

Paul Caselton
Deputy General Counsel -- Income Tax

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[1] Under current provisions of Section 1397E and Temporary Treasury Regulation Section 1.1397E-1T, the QZAB Bonds proposed to be issued by IDFA are the only QZAB Bonds authorized to be issued for the benefit of Illinois school districts. (In 1998, the xxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx issued $14 million of QZAB Bonds. Those bonds are not the subject of this letter.)

[2] Copies of Section 1397E and Temporary Treasury Regulation Section 1.1397E-1T are attached to this letter.

[3] The QZAB Bonds to be issued by IDFA will not bear interest.

[4] The bonds referred to in this provision include bonds issued by IDFA under the Local Government Assistance Program. Other bonds qualifying for exemption under this provision are described under Illinois Administrative Code, Title 86, Chapter I, Part 100, Subpart E; and in Illinois Department of Revenue Publication 101 (Income Exempt From Tax).